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## A Tax-Trap for the Unwary: The Disposition of Installment Obligations

Ellsworth W. Jones  
*University of Montana School of Law*

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# **A Tax Trap for the Unwary:**

## **The Disposition of Installment Obligations**

**Ellsworth W. Jones\***

### **INTRODUCTION**

Generally, Section 453 of the Internal Revenue Code of 1954 allows an attractive election in reporting gain from the sale of property when the seller receives only a small down payment in the year of sale and the buyer obligates himself to pay the balance of the purchase price in installments over a period of time. If certain requirements are met the seller may elect to apportion the payments he receives each year between the return of his basis for the property sold and the gain realized. This allows him to spread the income tax on his gain over the period of payment.<sup>1</sup>

The section does more than give the seller a tax choice. It also provides for the computation of gain or loss at the time that an installment obligation is satisfied at other than its face value, distributed, transmitted, sold, or otherwise disposed of.<sup>2</sup> Thus, the seller faces a possible tax-trap. He may later innocently deal with the installment obligation—even without receiving cash—in a manner that will immediately accelerate the income tax on his unreported gain. This penalty provision covers more than just an outright sale or exchange of the installment obligation for other property. It may extend to repossession of the property, modification of the original agreement, gift, transfer to a trust, or a pledge of the installment obligation as collateral for a loan. It also has some tax implications in the organization, liquidation, or reorganization of partnerships and corporations.

### **THE STATUTORY PROVISIONS CONSIDERED**

Although under Section 453(d) the holder generally recognizes gain or loss when he sells, transmits, distributes, accepts less than face value in satisfaction, or otherwise disposes of an installment obligation,<sup>3</sup> the exact amount recognized depends on the nature of the disposition. If the holder accepts satisfaction at less than face value, or sells or exchanges it for other property, he measures the amount by the difference between the basis of the obligation in his hands and the amount he realizes from the

<sup>1</sup>INT. REV. CODE OF 1954, § 453(a), (b). Without this election a sales transaction is ordinarily considered closed and the entire gain taxed in the year of the sale, even though the seller has not yet received all the sales price. For an extended discussion on how this section operates see Jones, 'Deferred Payment Sales: The Installment Sale Provisions Re-examined,' 1 GONZ. L. REV. 53 (1966).

<sup>2</sup>INT. REV. CODE OF 1954, § 453(d).

<sup>3</sup>There are some exceptions and special rules for transfers to a controlled corporation in exchange for stock or securities, transfers to a partnership, distributions by a partnership to a partner or by a corporation in some types of liquidations, some exchanges of property for stock or securities in corporate reorganizations, and a transfer because of death. INT. REV. CODE OF 1954, § 453(d) (3) and (4); Treas. Reg. § 1.453-9(c) (2) (1965).

transaction. If he distributes, transmits, or disposes of the obligation other than by a sale or exchange, he measures his gain or loss by the difference between his basis and the fair market value of the installment obligation itself.<sup>4</sup> Basis refers to the difference between the face amount of the obligation and the amount of income the holder would have had to report had the obligation been paid in full.<sup>5</sup> Further, the type of gain or loss (ordinary or capital) is the same type as reported for the original sale.<sup>6</sup>

The following example shows how the holder of an installment obligation computes his gain or loss from a simple sale.

**EXAMPLE:** In 1966, a taxpayer sells shares of stock, acquired in 1960 at a cost bases of \$10,000, for \$20,000. He receives a \$5,000 cash down payment and installment notes for the \$15,000 balance payable over the next three years, and reports his \$10,000 gain from the transaction on the installment basis for that tax year. The taxpayer would have a \$2,500 capital gain from the transaction in 1966.

$$\begin{array}{r} \$10,000 \\ \hline \text{X } \$5,000 = \$2,500^7 \\ \$20,000 \end{array}$$

In 1967, before receiving any more payments, he sells the notes for \$13,000 in cash. He computes his gain on the disposition in 1967 as follows:

|   |                |
|---|----------------|
| Proceeds from sale of notes .....   | \$13,000       |
| Sales price of property .....   | \$20,000       |
| Basis of property .....   | 10,000         |
|   | <hr/>          |
| Total Profit .....  | 10,000         |
| Total Contract Price .....  | 20,000         |
| Percentage of gain to be reported as income from the original sale, (\$10,000/\$20,000 = 50%) |                |
| Face Value of Notes .....   | 15,000         |
| Amount of income returnable, 50% X \$15,000 .....   | 7,500          |
| Basis of installment notes .....  | 7,500          |
| Taxable income for 1967 .....   | <u>\$5,500</u> |

<sup>4</sup>INT. REV. CODE OF 1954, § 453(d) (1) (B); Treas. Reg. §§ 1.453-9(a), (b) (1965). These rules for disposition apply only to installment obligations which have been reported on the installment basis under this section, not to other types of deferred payment sales. The term installment obligations refers to notes or other evidences of indebtedness given by the buyer, and also any contract right to receive payments.

<sup>5</sup>INT. REV. CODE OF 1954, § 453(d) (2); Treas. Reg. § 1.453-9(b) (2) (1965). Also, the holder takes the entire income into account in figuring the amount of income reportable for this purpose, not just the amount subject to the capital gain or loss limitations. *Blanche A. Lockhart*, 1 T.C. 804 (1943).

<sup>6</sup>INT. REV. CODE OF 1954, § 453(d) (1); Treas. Reg. § 1.453-9(a) (1965); *In re Rogers' Estate*, 143 F.2d 695 (2d Cir. 1944), *cert. denied*, 323 U.S. 780; 44-2 CCH U.S. Tax Cas. ¶9393. These rules apply only on a disposition by the holder, however. Afterwards, the installment obligation loses its characteristics and the transferee should be able to recover his cost tax-free without regard to the disposition provisions. I. T. 2547, IX-2 CUM. BULL. 120 (1930).

<sup>7</sup>The computation for reporting the profit each year on the installment basis is as follows:

If the taxpayer had disposed of his installment notes other than by sale or exchange, he would have to substitute the fair market value of the notes for the \$13,000 proceeds from the sale of the notes in order to arrive at his gain or loss for 1967.<sup>8</sup>

### FAIR MARKET VALUE AS THE MEASURE

The measurement for any gain or loss generally depends on "the amount realized," from a sale or exchange. However, in some instances the fair market value of the installment obligation itself may help determine the amount realized.<sup>9</sup>

In *Hegra Note Corporation*<sup>10</sup> the holder transferred seven installment notes in return for a certificate for 154,000 shares of stock under an agreement, requiring him to leave the stock certificate with the transferee to secure the payment of the principal and interest on the seven notes. If any default in these payments occurred the transferee would cancel the certificate and issue a new one only for the amount of the principal that had been paid.

The Commissioner maintained that there was a taxable gain for the difference between the basis of the notes transferred and the sale price of the stock as set out in the agreement. The holder admitted to the disposition, but argued that the transaction amounted to an exchange for other property, and that what he received under the agreement had no ascertainable fair market value on which to compute any gain.

After examining the terms of the transfer agreement, the court

| Gross Profit Realized  |   | Percentage |   | Payments |   | Profit |
|--|---|------------|---|----------|---|--------|
| Total Contract Price   | = | of         | X | for      | = | to     |
|  |   | Gain       |   | Year     |   | Report |
| Any gain resulting must be reported in full in the year of disposition, even though payment for the transferred installment obligations may also be received in installments. <i>Krist v. Commissioner</i> , 231 F.2d 548 (9th Cir. 1956), aff'g 12 CCH Tax Ct. Mem. 801, 56-1 CCH U.S. Tax Cas. ¶ 9424. |   |            |   |          |   |        |

<sup>8</sup>Treas. Reg. § 1.453-9(b) (3) (1965), examples (1) and (2). When a loss occurs prior returns cannot be amended, it must be taken in the year of disposition. G.C.M. 11845, Cum. Bull. XII-1, 52 (1933). The fair market value of installment obligations is not always their face value. See *John H. Denmark*, T. C. Memo. 1954-48; 13 CCH Tax Ct. Mem. 487 (1954) (50% of face value); *Emma M. Sanders*, T. C. Memo. 1957-229; 16 CCH Tax Ct. Mem. 1041 (1957) (value not over 35%).

Note that the holder of the installment obligation must return to the original sale and use his gain percentage from there in order to arrive at his basis.

<sup>9</sup>Although the statute does not define the amount realized, for this purpose, it will ordinarily be any cash paid or credited, or the fair market value of any property the holder receives on the sale or exchange of the installment obligation, determined under the general principles of tax law.

<sup>10</sup>*Hegra Note Corporation*, T. C. Memo. 1966-87; 25 CCH Tax Ct. Mem. 479 (1966). This decision contains an excellent discussion about the various tests used to determine when a stock purchase agreement is considered completed for tax purposes. Also, the case illustrates how the method of disposing of an installment obligation may alter the tax consequences somewhat. If the agreement had amounted to a sale with an immediate right to the stock for tax purposes, the holder would have probably realized more. The evidence showed that the asking price for the stock on the over-the-counter market was 2¼ a share at the date of transfer, a total of \$346,500. The court's 66% valuation of only his right (not the stock itself), based on the value of the installment notes, amounted to only \$254,100, \$92,400 less.

found that the holder did not actually or constructively receive the stock. But it also thought that, under the agreement, the holder did receive a right to the stock which had a fair market value on which to base any gain or loss from the disposition. Turning to the question of valuing this right, it concluded that the right had the same fair market value as the fair market value of the installment notes on the date transferred, which was 66 percent of the face amount. Thus, the holder had a gain for the difference between this value and his basis for the installment notes transferred.

Despite the apparent fusion of the two measures in this specific instance, the basic rules for determining any gain or loss still depend on the type of disposition. In this connection, available authority indicates that the holder of an installment obligation has some opportunity for tax planning. If properly alerted, he may alter his proposed transaction in some cases and avoid a disposition altogether. When he cannot do this because of his particular situation, he might consider casting it in a form which will bring one measurement or the other into play to obtain an entirely different tax result.<sup>11</sup>

### DISCOUNTS, LOANS AND PLEDGES

An outright sale<sup>12</sup> for cash is the most obvious type of disposition. But some holders of installment obligations have tried to escape the tax consequences by claiming the transfer was not complete because they remained liable as endorsers or guarantors. Others have attempted to avoid an outright transfer by merely borrowing money on the security of the obligation. Generally, they have met with little success.

In *Alworth-Washburn Co. v. Helvering*<sup>13</sup> the holder of installment

<sup>11</sup>The present section 453(d) of the INT. REV. CODE OF 1954 reenacted section 44(d) of the INT. REV. CODE OF 1939 changing only the rules for treatment of installment obligations at death, and clarifying the recognition of gain distributions in some corporate liquidations under sections 332 and 337 of the INT. REV. CODE OF 1954. Because of the similarity among the provisions, cases decided under the 1939 Code have been cited in this article where applicable.

Since the provisions allowing a taxpayer to report gain from the sales of personalty or real property on the installment basis may also apply to dealers in some instances, cases involving dealers have also been cited as authority wherever appropriate. The provisions which apply to dispositions speak broadly in terms of the holder. Thus, they will apply to individuals (dealers or not), partnerships, or corporations, anyone electing to report gain on the installment basis, unless they come within the statutory exceptions set out, or the distinctions found in the court cases and Internal Revenue rulings.

<sup>12</sup>A forced sale of installment notes (pledged as security) by the holder's creditors can amount to a disposition, even though after the proceeds of the sale were credited to the holder's debt he was insolvent and still owed a deficiency. In one case the court held that gain was realized on the amount of unreported income in the installment contracts through the reduction of the debt. The amount realized was the amount credited on the note. *Home Builders Lumber Co. v. Comm.*, 165 F. 2d 1009 (5th Cir. 1948) aff'g 5 CCH Tax Ct. Mem. 1054 (1946), 48-1 CCH U.S. Tax Cas. ¶ 9182.

<sup>13</sup>67 F.2d 694 (D.C. Cir. 1933), 3 CCH U.S. Tax Cas. ¶ 1167; *Winding River Ranch, Inc.*, T.C. Memo. 1966-260, 25 CCH Tax Ct. Mem. 1335 (1966), also found a sale, not a loan with the note pledged as security, when the holder discounted installment notes to a bank in the same year received for less than their face value.

notes representing the balance of the sales price for land endorsed them in blank to a bank in return for a sum of cash equal to the full face value, plus interest. The holder argued that through its endorsement it incurred a contingent liability to the bank which deferred any gain until the liability was extinguished by the payment of the notes.

The court refused to distinguish a "loan," "discount," or "sale." The transfer effected a complete change in title to the bank; the taxpayer had received the full balance of the sales price in cash. According to the court: ". . . except for its contingent liability as endorser, the transaction was closed and the installment feature abandoned." Any endorser liability was a new relationship.

A sale may also take place where the installment obligations are transferred for a combination of cash and credit and an agreement to repurchase in case of default. In *Della Nickol et al.*<sup>14</sup> a clothing store reporting income from some of its sales on the installment basis transferred these "accounts receivable" to a finance company. The loan agreement contained the words "sell, assign, transfer" and provided for 3½% discount. Out of the remaining balance only 75% was actually paid; the other 25% was withheld as a reserve, and the taxpayer agreed to repurchase any defaulted accounts after notice. The court held that the evidence indicated a sale, not a pledge as security for loans. The accounts were "all assigned outright to the finance company." The taxpayer did not give any notes for the money received, nor did the agreement make mention of any loans.

Another case<sup>15</sup> also failed to find any loan arrangement, noting that the transfer documents used the language of a sale. The transferee treated it as a purchase and did not lend money to the taxpayer. Further, the taxpayer did not execute any notes to the transferee, nor did he pay interest or financing charges.

Where the holder of an installment obligation assigns it outright for cash, but remains contingently liable in some manner, the courts have had little trouble in finding two transactions. One, the sale which creates a gain or loss. The other, a separate agreement back to the transferor containing different rights, duties, and consequences. Similarly, they have

<sup>14</sup>10 CCH Tax Ct. Mem. 861 (1951). Other cases have found a sale under similar facts. E.g. *Robinson v. Commissioner*, 73 F.2d 769 (9th Cir. 1934) *rev'g and remanding* 28 B.T.A. 788 (1933), 4 CCH U.S. Tax Cas. ¶ 1363; and *Packard Cleveland Motor Co.*, 14 B.T.A. 118 (1928) deal with guarantees. *Thomas Goggan & Brothers*, 45 B.T.A. 218 (1941) and *James Hammond*, 1 T.C. 198 (1942) cover obligations in case of defaults.

<sup>15</sup>*East Coast Equipment Co. v. Comm'r*, 222 F.2d 676 (3d Cir. 1955) *aff'g* 21 T.C. 112 (1953), 55-1 CCH U.S. Tax Cas. ¶ 9463. In this case the installment obligations were lease agreements whereby the lessee could take title to the equipment if he wanted to upon the final lease payment. Apparently the lessor wanted to treat the lease agreements as installment sales because, if he had not, the entire profit would have been taxed in the year the lease agreements were entered into.

When a single transaction results in a series of notes and not all of them are sold, it appears possible to continue reporting the profit from the unsold obligations by the installment method, *Duram Building Corporation v. Comm'r*, 66 F.2d 253 (2d Cir. 1933), *rev'g* 23 B.T.A. 796 (1931).

applied the same conclusions in meeting the argument that the transaction amounted to only a pledge of the installment obligation, not a completed sale. In most of these cases, however, the terms of the transaction have lacked some of the essential elements the courts thought necessary for a true loan arrangement. Thus, the question remains: Can the holder of an installment obligation avoid a sale by merely pledging it as collateral security for a loan?

Apparently the Internal Revenue Service will examine any such arrangement using a test of substance over form. One ruling<sup>16</sup> considered a dealer who sold cars for a cash down payment plus a conditional sales contract for the balance, payable in installments. After the sale the dealer would assign the conditional sales contract to an unrelated finance company as collateral security for a loan substantially equal to the face amount of the contract. The loan agreement provided for the dealer to execute a note to the finance company which called for repayment over the same term, and in the same amounts, as the pledged contract. The installment payments were to be paid directly to the finance company by the contract's vendee and applied toward repayment of the dealer's note. If the dealer's vendee failed to make a payment, the dealer had to make that payment.

The ruling held that the loan arrangement (except for form) was the same as an outright sale with recourse or other guarantee in case of default. Although the dealer did execute his own note to the finance company, he did not have to make any payments unless there was a default in payment on the contracts held at security. Also, he received cash substantially equal to the face amount of the contract. Thus, the transfer amounts to a "disposition" of the conditional sales contract under the installment sales provisions.

Although this ruling seems to indicate a rather limited use for installment obligations as collateral security for loans, it does provide some ground rules for setting up a true loan transaction.

At least one case indicates that a loan arrangement does not always amount to a sale or disposition. In *Prescott Corporation v. United States*,<sup>17</sup> the court considered a transfer of 130 conditional sales contracts by assignment (along with delivery of deeds) as merely a security precaution because the parties intended and treated them as loans. Unfortunately, the court did not relate any more facts for this conclusion. Nevertheless, the case does stand for the proposition that not all loan arrangements using installment obligations as collateral security need cause a sale or

<sup>16</sup>Rev. Rul. 65-185, 1965-2 CUM. BULL. 153. Rev. Rul. 55-292, 1955-1 CUM. BULL. 331, held that gain resulted on a sale of installment notes to a building and loan association where stock certificates from the association were given in partial payment, even though the stock certificates had to be pledged to the association as additional collateral for the notes.

<sup>17</sup>.....F. Supp. .... (D.C. Ore. 1964), 64-2 CCH U.S. Tax Cas. ¶ 9879. See also *Miller Saw-Trimmer Company* 32 B.T.A. 931, appeal dismissed by 3d Cir. Ct. App.

other disposition. When considered along with the facts relied upon in the rulings and cases that found otherwise, some definite guidelines appear. In setting up an acceptable loan arrangement the holder of an installment obligation should provide:

First, that he execute an unconditional promissory note to the lender, which provides for repayment on entirely different terms than those of the installment obligation pledged for security.

Second, that he receives payments under his installment obligation directly from his debtor, and in turn, makes payment directly to his lender on his note, whether or not he has received a payment.

Third, that the amount borrowed does not substantially equal the face amount of the installment obligation used for collateral security.

Fourth, that he does not divest himself completely of ownership in the installment obligation assigned as collateral security for the loan.

Finally, he should keep away from a consistent practice of borrowing on all the installment obligations he holds. A continuous pattern of financing with installment obligations seems to be viewed with disfavor.

### EXCHANGES, SUBSTITUTIONS AND MODIFICATIONS

The transfer of an installment obligation as part payment for the purchase of other property amounts to an exchange which results in a gain or less in the year of transfer, even though the holder must guarantee its payment. A guarantee does not mean that the holder has not disposed of the installment obligation.<sup>18</sup>

A disposition may occur when one installment obligation is exchanged for another. In *Burrell Groves, Inc.*,<sup>19</sup> a taxpayer sold property to its stockholders and reported gain on the installment basis. The stockholder-purchasers then sold the property to a partnership. Under the terms of the sale, the corporation surrendered the mortgage and notes received in the first sale in exchange for partnership notes (secured by a mortgage) payable in different amounts, at different times, and with a different interest rate. The differences between the installment obligations originally held by the corporation, and those received from the partnership in the exchange was enough to cause a disposition, according to the court's reasoning. In effect, the original obligation was cancelled and satisfied in exchange for a new obligation with a different debtor.

A straight exchange transaction, however, should be distinguished from a mere substitution of debtors or limited modification of the terms.

<sup>18</sup>*E.g., Robinson v. Comm'r, supra* note 14. In Leslie M. Lockhart, 1 CCH Tax Ct. Mem. 908 (1943) the transfer of a series of purchase money notes back to the debtor in exchange for a certain fractional interest in oil-producing properties was considered a disposition.

<sup>19</sup>22 T.C. 1134 (1954), *aff'd*, 223 F.2d 526 (5th Cir. 1955), 55-1 CCH U.S. Tax Cas. ¶ 9515.



The holder does not have an exchange of his installment obligation when his debtor sells the underlying property and a second debtor assumes payment, even though the holder accepts the novation. The holder may even deal with the second buyer later on and modify the terms of the installment obligation.

Both these events occurred in *John I. Cunningham v. Commissioner*,<sup>20</sup> after the taxpayers sold stock to a corporation for cash and installment obligations. The buyer then sold the stock to another corporation which assumed the payments on the same terms and conditions. The taxpayers joined in this second transaction and agreed to release the first debtor for payment of the installment obligation. Some time later the taxpayers modified the terms with the new debtor by agreeing to a reduction of the principal amount, and waived interest.

Taking a practical approach, the court held that the assumption of the installment obligations by a new debtor did not result in a gainful disposition because afterwards the holders "had no more or less than they had in the beginning." Considering the modifications agreed to by the holders, the court commented:

Neither the reduction of the principal amount of installment obligations nor the waiver of interest thereon necessarily connotes a disposition of the obligation.

The court also suggested that the modifications would not have materially changed the situation even though they had occurred at the time the new debtor assumed the installment obligation.

At least two rulings have recognized the distinction between an exchange and a modification of an installment obligation where the debtor remains the same. One held that the holder may substitute a mortgage security for a land contract with the same unpaid balance, terms and conditions.<sup>21</sup> Another allowed the holder to modify the sales price and payments from the sale of a patent in order to meet the sales and profit experienced by the manufacturer.<sup>22</sup>

On the basis of these cases and rulings, it appears that the holder of an installment obligation has some leeway when he wants to make some adjustments to meet changing conditions. Still, he must keep certain guidelines in mind. If he exchanges the obligation for other property, he has a disposition subject to taxation. The same rule would apply to a substitution of debtors accompanied by major changes in the terms as to the amount and time of payments and interest charged. But, he

<sup>20</sup>44 T.C. 103 (1965). In *J.C. Wynne*, 47 B.T.A. 731 (1942), the court refused to consider a change of the debtor alone as a disposition. There a corporation dissolved and transferred its assets (including an installment obligation owed the taxpayer) to a partnership which assumed the liability. The court considered that only the disappearance of the installment obligation or its removal from the hands of the obligee creditor created a disposition.

<sup>21</sup>Rev. Rul. 55-5, 1955-1 CUM. BULL. 331.

<sup>22</sup>Rev. Rul. 55-429, 1955-2 CUM. BULL. 252

may deal directly with the original debtor and substitute a different form of security, or modify the sales price and payments. Possibly, he may combine all three in one adjustment. He may agree to a substitution of debtors under the obligation without more. Apparently, he may even make minor adjustments in the principal amount, or interest charged, at the same time. If he goes farther, however, and not only accepts a change of debtors, but also accepts too many changes such as the face amount due, the time and amount of payments, and the interest charged, he has substituted or exchanged the original installment obligation, which amounts to a disposition.

### REACQUIRING THE PROPERTY SOLD

The repossession or reacquisition of property because of defaults in payments or other terms, amounts to a satisfaction of the installment obligation at other than face value, but the rules applied to determine any gain or loss differ, depending on whether the installment obligation represents a sale of personal or real property.

#### *Repossessing Personal Property*

When the installment obligation covers a sale of personal property, the holder has a gain or loss for the difference between the property's fair market value at the time reacquired and the basis of the installment obligations satisfied or discharged, with proper adjustments for any other amounts realized, or costs incurred in connection with the repossession. This formula applies to the repossession whether title has been retained as security or transferred to the purchaser. If the property is reacquired by bid at a lawful public auction or judicial sale, this price is considered the fair market value in the absence of convincing proof to the contrary.<sup>23</sup>

A bad debt deduction may result from a repossession if any portion of the obligation is not satisfied, discharged or applied at the time and the purchaser remains liable, but the amount cannot exceed the basis for this portion.<sup>24</sup>

<sup>23</sup>Treas. Reg. § 1.453-1(d) (1966). Basis is the difference between the face amount of the obligations satisfied or discharged or applied to the purchase or bid price of the property, less the amount of any income returnable had they been paid in full. These rules apply both to sales by a dealer in personal property or a person who has made a casual sale or other casual disposition of personalty. However, there are some other special rules applicable to dealers in personal property. Treas. Reg. § 1.453-2 (1965). Ordinarily, the basis of the repossessed property becomes its fair market value in determining gain or loss for a later sale. See Treas. Reg. § 1.166-6; A.R. Calvelli, 43 B.T.A. 6 (1940). The character of the gain realized on the original sale determines whether the repossession results in capital or ordinary gain or loss. Rev. Rul. 64-178, 1964-1 CUM. BULL. 171. When the bid price includes both unpaid principal and interest, however, the accrued interest is taxed as ordinary income. T. Eugene Piper, 45 B.T.A. 280 (1941), *acquiesced in*, 1941-2 CUM BULL. 10.

<sup>24</sup>Treas. Reg. § 1.453-1(d) (1966). See *Boca Ratone Co. v. Comm'r*, 86 F.2d 9 (3d Cir. 1936), *rev'd* 31 B.T.A. 1060, 36-2 CCH U.S. Tax Cas. ¶ 9479; T. Eugene Piper, *supra* note 23; Pacific Refrigeration Co., 2 T.C. Memo. 141 (1943) for examples of the computation of gain or loss upon repossession.

When the fair market value of the property on the repossession date exceeds the original sales price, the holder may end up paying tax on any increase without

The rules for determining gain or loss on a repossession have also been applied where the holder of an installment obligation reacquires the property by repurchase or cancellation of the sale. In *Herbert R. Spencer v. Granger*<sup>25</sup> a dispute arose between the holder and the buyer under an installment obligation for the sale of stock. Originally, a compromise agreement called for the complete cancellation and rescission of the original sales agreement, except for 376 shares already paid for. The terms of this agreement were not followed, however. Instead, the buyer paid the unpaid balance from the installment sale, and the seller, then, gave the buyer his check in return for the entire amount of stock originally sold. The evidence revealed that the buyer (obligor) under the installment sales agreement was not content to surrender his stock interest for the value set out in the original installment sales agreement, so the seller (obligee) had to pay a premium to recover the stock.

The court stressed this fact, when it accepted the contention of the tax authorities that the transaction constituted either a repurchase or a repossession. It held that the installment sales agreement was not rescinded, but discharged by the new agreement, for a taxable gain. All the facts indicated that the transaction was not designed to cancel the prior contract, but merely to shift corporate control.

Although the *Granger* decision suggests a distinction between a repossession and a cancellation<sup>26</sup> or rescission of an installment obligation, at least one case has considered a cancellation and return of the property as a satisfaction at other than face value. In *United States v. Walter Eversman*<sup>27</sup> the installment contract gave the obligors (buyers) the right

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receiving any money. He would recover this increase, however, in his basis on later sale. Also, he apparently might have both a loss on the repossession and a bad debt deduction for any portion of the installment obligations not satisfied or cancelled by the repossession.

<sup>25</sup>102 F. Supp. 205 (W.D. Pa. 1952), 52-1 CCH U.S. Tax Cas. ¶ 9244. Unfortunately, the facts here do not show how the taxable gain was figured, but apparently the repossession rules were applied by taking the difference between the fair market value of the stock reacquired and the basis of the installment obligation. Also, there is no indication of how the additional amounts paid by the holder were treated. The facts indicate the gain was the same whether the transaction was considered a repossession or repurchase.

In *Boca Ratone Company*, *supra* note 24, the holder reacquired the property on default by paying \$450 and releasing the buyer from any further liability under the agreement. The court there treated the transaction as a repossession for satisfaction at other than face value by the \$450 payment and the value of the land returned, commenting: "When the transaction was over the purchasers were released and discharged from the obligation. It was at an end and this within the meaning of the statute constituted a satisfaction of the obligation." *Boca Ratone*, *supra* note 24 at 11. This case was followed in *Walker v. Thomas*, 119 F.2d 58 (5th Cir. 1941), 41-1 CCH U.S. Tax Cas. ¶ 9370; *Wilcox v. Hendrickson*, 31 F. Supp. 700 (W.D. Wash. 1940), 40-1 CCH U.S. Tax Cas. ¶ 9267. See also *Lucille L. Morrison*, 12 T.C. 1178 (1949) (repossession by forfeiture).

<sup>26</sup>Conceivably a complete rescission of the agreement should not be considered a satisfaction of the installment obligation where the parties are returned to their original positions. The seller regains his property and the buyer receives back the payments made. In most cases, however, the buyer loses his payments.

<sup>27</sup>133 F.2d 261 (6th Cir. 1943), 43-1 CCH U.S. Tax Cas. ¶ 9284, *aff'g* 41-2 CCH U.S. Tax Cas. ¶ 9581. In this case both the election to report the gain on the installment basis and the repossession occurred in the same taxable year. Undoubtedly, the holder

to cancel the sale and return the property if they had paid at least \$40,000, and had not defaulted in any other terms. The buyers exercised this provision and returned the property. The Commissioner maintained that since the installment obligation was cancelled in accordance with the contract, there was not a satisfaction at other than face value. The court held that the obligation had been satisfied by the \$40,000 payment and the surrender of the property. Since the fair market value of the returned property was less than the holder's basis for the installment obligation, he had loss on the transaction.

The *Granger* and the *Eversman* decisions indicate that any time the holder reacquires personal property sold under an installment obligation, whether by repossession, repurchase, rescission, or cancellation, he will have to treat the transaction as a satisfaction at other than face value in determining the gain or loss. The amount realized must be measured by the difference between the fair market value of the property reacquired and the basis of the installment obligation. In such situations, the regulations also allow the holder a "proper adjustment for any other amounts realized or costs incurred in connection with the repossession."<sup>28</sup> Presumably, this should allow him to reduce his gain by any amount he must pay in order to reacquire the property.

### *Repossessing Real Property*

Before September 2, 1964, the tax law covering the repossession or reacquisition of property drew no distinction between personal or real property. Now, however, the holder of an installment obligation from the sale of real property, upon repossession or reacquisition, must look to a new section of the Internal Revenue Code to determine any gain or loss.<sup>29</sup> This new section requires only three conditions for application: (1) a sale of real property; (2) an indebtedness secured by the property; and (3) a reacquisition of the property in partial or full satisfaction of the debt. When these conditions are met, this section will control, and any

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chose this approach because the net effect of both transactions gave him a deductible loss, since the fair market value of the property on repossession was lower than his basis for the installment obligation. If the reverse were true, however, the holder would have to pay a tax on any gain from both transactions. Thus, a holder in this type of situation would have to examine his entire tax picture before electing to report the sale on the installment basis and repossession of the property in the same year.

<sup>28</sup>Treas. Reg. § 1.453-1(d) (1958). If the holder receives any additional amounts on the repossession, they will increase his gain, of course.

While the formula involves only the amount of gain or loss realized, it also indicates a cost basis for the reacquired property corresponding to the amount used to measure the gain or loss. INT. REV. CODE OF 1954, §§ 1001(b), 1011, 1012; Treas. Reg. § 1.1001-1(a) (1957); Treas. Reg. § 1.1012-1(a) (1957). Ordinarily this will be the fair market value of the property at the time it is reacquired.

<sup>29</sup>INT. REV. CODE OF 1954, § 1038, added by section 2 (a) of Public Law 88-570, Sept. 2, 1964, 78 Stat. 854, 1964-2 CUM. BULL. 647, applies for taxable years beginning after September 2, 1964. The section may also apply to taxable years beginning after December 31, 1957, and before September 3, 1964, not otherwise barred by law, if an election was made by filing an amended return or a refund claim before September 3, 1965. Treas. Reg. § 1.1038-3 (1967).

gain will be recognized notwithstanding any other provision of the tax law.<sup>30</sup>

It is immaterial whether the property reacquired has appreciated or depreciated in value, whether gain or loss resulted on the original sale, or whether it is even possible at the time of sale to determine the amount of any gain or loss.<sup>31</sup>

A sale occurs for this purpose (although title does not pass) when the purchaser has a contractual right to retain possession of the property by performing the contract obligations and to obtain title upon completion, and, also, when the purchaser does not have an immediate right to possession until after he pays a portion of the purchase price.<sup>32</sup>

A debt is secured by the real property whenever the seller has the right to take title or possession, or both, upon default. The reacquisition must take place in furtherance of the seller's security rights in the property, however. A debt exists, even if the seller's recourse on default is limited to the property.<sup>33</sup>

Generally, Section 1038 will apply even though the seller pays some additional amounts to the defaulting purchaser during the course of the repossession. It also applies when the purchaser has not defaulted and a default is not imminent, if the seller does not pay additional consideration in order to reacquire the property.<sup>34</sup>

Payments by the seller include money and other property transferred, along with the amount of any indebtedness assumed that arose after the original sale. This does not include, however, any debt or assumption of debt that existed before, or came out of the original sale.<sup>35</sup>

<sup>30</sup>Although restricted to sales of real property the section does not apply to installment sales alone. It also covers all deferred payment sales not qualifying or reported on the installment basis, and to the sale of a principal residence in most instances. Treas. Reg. § 1.1038-2 (1967).

It does not apply, however, to exchanges or sales of property under INT. REV. CODE OF 1954 §§ 121 (d) (4) or 1034 (i), nor to sales of stock in a cooperative housing corporation described in § 121 (d) (3), or § 1034 (f). Treas. Reg. § 1.1038-1 (a) (2) (i) (1967). Further, reacquisitions of real property by mutual savings banks, domestic building and loan associations, and cooperative banks, described in § 593, are excluded. Treas. Reg. § 1.1038-1(a) (5) (1967).

<sup>31</sup>Treas. Reg. §§ 1.1038-1(a), (e) (1967).

<sup>32</sup>Treas. Reg. § 1.1038-1(a) (2) (i) (1967).

<sup>33</sup>Treas. Reg. § 1.1038-1(a) (2) (ii) (1967). These rules will cover the typical land contract and purchase money mortgages or other security devices.

<sup>34</sup>Treas. Reg. § 1.1038-1 (a) (3) (i) (1967). This section does not apply when the seller reacquires the property by discharging the debt and paying additional consideration, when a default has neither occurred nor appeared imminent, unless the reacquisition and the additional payments are provided for in the original contract of sale.

Apparently, without a default and a provision for paying additional amounts on a repossession in the original contract, the reacquisition of the property in this manner will be treated as a disposition of an installment obligation with a recognized gain or loss outside the rules of this section.

<sup>35</sup>Treas. Reg. § 1.1038-1(a) (3) (i) (1967). These rules should cover any payments for rights of reacquisition required by law to a defaulting purchaser under a land contract, and also cover the situation where the seller must assume or otherwise provide for a construction loan outstanding on the repossession date.

Section 1038 does not base the measurement of gain on the fair market value of the repossessed property. Instead, it taxes any gain to the extent that the payments received by the holder before the repossession date exceed the gain previously reported as income. It further limits this to the entire amount of gain on the original sale, reduced by the amount of gain reported as income plus any money paid or property transferred by the holder in connection with the repossession.<sup>36</sup>

Amounts received by the holder include payments made directly to him, or payments made either for the holder's benefit or upon any encumbrances assumed by the purchaser at the time of sale. These will include any payments the holder receives at the time he repossessed the property. They do not include any payments made by the purchaser on any indebtedness arising after the sale, because he has borrowed money and used the property as security for this separate debt.

Stated or unstated interest received by the holder, however, is not included in the computation for determining the gain from the sale, nor for determining the amounts of other money or property received.<sup>37</sup>

Generally, amounts paid by the holder that enter into this deduction will include such items as court costs, payments to an attorney, trustee, or auctioneer, and fees for publication, acquiring title, clearing liens, or filing and recording.<sup>38</sup>

The following example illustrates the computation to be used when the holder of an installment obligation from the sale of real property repossesses the property.

**EXAMPLE:** The owner sells real property, having adjusted basis of \$20 in his hands, for \$100, under a contract where the purchaser pays \$10 down and executes a note for \$90 (interest at 6%) payable in nine annual installments. After the second annual \$10 payment the purchaser defaults and reconveys the property in complete satisfaction of the debt. The holder pays \$5 in filing fees.

#### Basic Computation of Gain:

|  |       |
|--|-------|
| Payments Received Before Default ..... | \$ 30 |
| Less: Gain Reported as Income .....    | 24    |
|  | ----- |
| $\$30 \times (\$100 - \$20) / \$100$   |       |
| Tentative Gain .....                   | \$ 6  |
|  | ===== |

<sup>36</sup>Treas. Reg. § 1.1038-1(b) (1) (1967).

<sup>37</sup>Treas. Reg. § 1.1038-1(b) (2) (iii) (1967).

<sup>38</sup>INT. REV. CODE OF 1954, § 1038 (b) (2) (B); Treas. Reg. § 1.1038-1 (c) (4) (1967). Apparently the holder may pay additional consideration if default has occurred or is imminent; but these rules will not apply where the "reacquisition" of the property amounts to a repurchase. S. Rep. No. 1361 88th Cong. 2d Sess. (1964).

## Limitation on Amount of Gain:

|                                   |       |
|-----------------------------------|-------|
| Sales Price of the Property ..... | \$100 |
| Less: (a) Adjusted Basis .....    | \$20  |
| (b) Gain Reported as Income ..... | 24    |
| (c) Fees Paid .....               | 5     |
|                                   | <hr/> |
| Total Reduction .....             | 49    |
|                                   | <hr/> |
| Limitation on Gain .....          | \$ 51 |
|                                   | <hr/> |
| Gain on Reacquisition .....       | \$ 6  |
|                                   | <hr/> |

In order to account for any gain or loss reflected by the fair market value of the property at the time reacquired for a later sale, the rules also prescribe a substitute basis for the property. It is defined as the adjusted basis of the installment obligation at the repossession date, plus the gain realized and any expenses and costs incurred in reacquiring the property.<sup>39</sup>

Assuming the same facts as in the example immediately above, the holder will determine his basis for the repossessed property as follows:

|                                       |       |
|---------------------------------------|-------|
| Basis of Installment Obligation ..... | \$ 14 |
| \$70 - (\$70 X \$80/\$100)            |       |
| Gain on Reacquisition .....           | 6     |
| Fees Paid on Reacquisition .....      | 5     |
|                                       | <hr/> |
| Substitute Basis for Property .....   | \$ 25 |
|                                       | <hr/> |

## DISPOSITIONS BY GIFT

A transfer of an installment obligation as a gift comes within the "otherwise disposing of" provisions of Section 453(d) and the fair market value of the installment obligation at the time of the gift is used to measure the gain.<sup>40</sup> When the transfer is to an educational institution or other charitable organization, the transfer may also give rise to a charitable deduction for the full fair market value of the installment obligation.<sup>41</sup>

<sup>39</sup>INT. REV. CODE OF 1954, § 1038(c); Treas. Reg. §§ 1.1038-1 (g) (1), 1.1038-1 (h) (1967), example (1). Also the basis for any part of the installment obligation not discharged by the reacquisition will be zero. Further, the holding period for the property on resale includes the period the property was held before the sale, plus the period held after the reacquisition, but not the period from the original sale to the reacquisition. Treas. Reg. § 1.1038-1(g) (3) (1967). No debt shall become worthless, or partially worthless, as a result of a reacquisition. INT. REV. CODE OF 1954, § 1038(a).

<sup>40</sup>I.T. 3293 1939-1, CUM. BULL. 183; John H. Denmark v. Comm'r, T.C. Memo. 1954-48, 13 CCH Tax Ct. Mem. 487. A transfer of this type also has some gift tax consequences to consider.

<sup>41</sup>In Rev. Rul. 55-157, 1955-1 CUM. BULL. 293, the taxpayer sold real property to an educational institution and elected to report his profit on the installment basis. Each time a payment fell due he would donate the note to the organization and take a

On the other hand, a district court case has applied a different measure where the installment obligation was extinguished by the gift. In *Miller v. Usry*<sup>42</sup> the taxpayer sold land to his son for cash and a balance represented by a 20-year note payable in annual installments and secured by a mortgage. He reported the gain on the installment basis and paid income tax on the amount recovered in the year of sale. The next year he gave his son the note marked "cancelled in full" across its face, and cancelled the mortgage. Both acts were fully recorded according to state law and a gift tax return was filed. Faced with a claim for tax on the difference between the fair market value of the installment obligation and its basis, under the theory that the cancellation disposed of the note other than by sale or exchange, he argued that his cancellation merely satisfied the obligation at other than face value.

The court agreed. He did not dispose of the obligation because he did not transfer an existing and enforceable installment obligation. Nor was it distributed, transmitted or sold. The payment in the year of sale (on which income tax was paid), and the cancellation of the balance due satisfied the obligation at other than face value. Thus, the "amount realized" should be used to measure the gain. Since income tax had already been paid on the previous payment and "the note was as of the instant of cancellation, nothing but a worthless scrap of paper," the holder did not realize any amount at the time of the gift by cancellation on which to measure any gain.

The problems raised in these cases demonstrate that installment obligations are not the most desirable assets with which to make a gift. If the holder transfers them to a third party who collects the payments, he not only has a disposition for income tax purposes, but also, a transfer with gift tax consequences. Even if he transfers them to a type of donee which will allow him an income tax deduction for a charitable contribution, this will be offset by income tax on the gain he must report from the transfer. While there is some authority indicating that a choice of a cancellation rather than the outright transfer of the obligation may result in tax savings, this would apply only where the holder wants to make a gift to the debtor or obligor of the installment obligation.<sup>43</sup>

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charitable deduction. He was held taxable on any gain between the basis of each note and its fair market value at the time of the gift.

In Rev. Rul. 60-352, 1960-2 CUM. BULL. 208, a limited partner transferred his interest in a partnership, which held installment obligations, to a charitable organization. The gift was considered a two-part transfer. One part, a disposition of the installment obligations with the gain taxed as ordinary income. The other part, a transfer of the value of his limited partnership interest (a capital asset), exclusive of his share of the partnership's installment obligation, on which no gain or loss resulted because a sale or exchange did not take place within the meaning of the Internal Revenue Code provisions dealing with partnerships. At the same time, the partner had a charitable deduction for the fair market value of both interests.

<sup>42</sup>160 F. Supp. 368 (W.D. La. 1958), 58-1 CCH U.S. Tax Cas. ¶ 9393.

<sup>43</sup>Actually, there appears to be no reason why the same principle would not apply where the debtor is a charitable or educational organization, and the holder merely cancels the obligation. However, he would probably lose any income-tax deduction for a charitable contribution, since under this theory he has not transferred anything of



## TRANSFERS TO AND FROM TRUSTS

Ordinarily, a complete transfer by the holder of an installment obligation to a trust—even where the holder creates the trust for his own benefit—amounts to “otherwise disposing of” the obligation and accelerates the unreported gain.

In *Elizabeth J. Marshal v. United States*<sup>44</sup> the holder of a promissory note and mortgage from the sale of property had reported the gain on the installment basis, and later transferred the note and mortgage to an irrevocable trust. The terms of the trust gave the trustee bank complete control of the trust property and directed it to pay the trust income to the holder during her lifetime.

The court held that the transfer to the trust was a disposition which resulted in gain to the extent of the excess of the fair market value of the installment note over the adjusted cost basis. The trust was irrevocable, and the holder of the installment obligation effectively disposed of any right to manage or control it.

Another case<sup>45</sup> found a taxable disposition of installment obligations to a testamentary trust where the executors acquired them by selling assets included in the estate. There the executors transferred the obligations to various trusts of which they were trustees, and to an escrow agent for a residuary legatee. The court held that this type of distribution came within the provisions “distributed, transmitted, sold or otherwise disposed of.” It refused to accept the executor’s contention that the transactions were without real substance because the installment obligations vested in the beneficiaries from the moment the estate acquired the obligations.<sup>46</sup>

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value. Even if he argued that the amount of debt forgiven should be counted, this, in turn, would give a measure for determining the “amount realized” by the cancellation.

<sup>44</sup>26 F. Supp. 580 (S.D. Cal. 1939), 39-1 CCH U.S. Tax Cas. ¶ 9320. Although the facts showed that after the transfer in trust the installment obligation ultimately did not pay out with the result that profit was never realized, the court said it had “to deal with the situation as it existed . . . considering the terms of the statute.”

<sup>45</sup>Estate of Henry H. Rogers, 143 F.2d 695 (2d Cir. 1944), cert. denied 323 U.S. 780, 44-2 CCH U.S. Tax Cas. ¶ 9394. The estate also requested an offsetting deduction in computing net income for the year for the value of distribution upon the ground that the income so taxed to the estate was “properly paid or credited during such year” to the residuary legatees. The court denied this request by finding that the installment obligations amounted to corpus, not income.

This case should be distinguished from a situation where the executor does not create the installment obligation himself, but acquires it from the decedent. Then the executor treats the obligation as items of “income in respect of a decedent” and the estate, heir, or other person receiving the installment payments reports the income the same as the decedent would have. INT. REV. CODE OF 1954, § 691(a) (4), Treas. Reg. § 1.691(a)-5(a) (1965).

<sup>46</sup>Cf. 1st National Bank of Greeley, Colorado v. United States, 86 F.2d 938 (10th Cir. 1937), 37-1 CCH U.S. Tax Cas. ¶ 9014, where a corporation transferred all its assets, including installment obligations, to a trustee in liquidation for the benefit of the stockholders. The court held that these provisions for accelerating gain on the disposition of installment obligations do not apply where an assignment is made to an alter ego for convenience. There was no disposition because the corporate life was

A similar result does not necessarily occur where the grantor transfers to a reversionary trust and retains some ownership rights. A recent revenue ruling<sup>47</sup> considered a transfer of an installment note to a trust when it still had over two years to run. The agreement provided that the trust should exist for two years and one month; that the interest income on the note should go to a named charitable beneficiary; and that the grantor should receive the deferred profit. On termination of the trust the installment note would revert back to the grantor. The ruling held that the grantor of the trust did not dispose of the installment obligation since he remained the owner of the profits from the installment obligation.

According to another ruling,<sup>48</sup> however, a disposition may take place on a transfer to a reversionary trust where the holder gives up too many rights for too long. There the grantor sold property for an installment note, plus interest, payable in monthly installments over a period of 20 years, and elected to report the gain on the installment method. Two years later he transferred the installment note in trust, and directed the trustee to distribute the entire amount of each installment and interest payment to his sister. At the end of a ten year, two month period the trust would terminate and the balance due would revert to the grantor.

The ruling held that since the grantor did not remain the owner of any part of the trust, the transfer in trust was a disposition of the installment note which resulted in recognition of the deferred gain measured by the difference between the basis of the obligation and its fair market value at the time of its transfer.<sup>49</sup>

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extended. It was a corporation liquidation (not a distribution in kind to its stockholders through a trustee), so the corporation was taxable on the profit from the trustee's liquidation.

<sup>47</sup>Rev. Rul. 67-70, Int. Rev. Bull. No. 1967-10. He was taxable, however, on the deferred profit part of the installment payments received by the trust under §§ 673 and 677(a) (1) of INTERNAL REVENUE CODE OF 1954. He was not taxable on the interest income from the installment obligation because it was irrevocably payable for a period of two years and one month to a charitable beneficiary described in §§ 170(b) (1) (4) (i), (ii), or (iii) of the CODE, and thus comes within the exception set out by § 673(b). The conclusion reached here should also apply to a transfer of an installment obligation to an inter vivos revocable trust in order to avoid probate. Since the grantor of a revocable living trust remains the owner of the trust for tax purposes, this ruling appears to cover that situation, and a transfer should not bring immediate taxation of the deferred profit.

<sup>48</sup>Rev. Rul. 67-167, Int. Rev. Bull. No. 1967-21. Contrast this ruling with the previous one (*supra* note 47) which did not consider the transfer in trust a disposition because the grantor retained the right to the deferred profit and principal payments. Only the interest was paid to someone else. Further, the trustee would return the installment note to the grantor before a ten-year period, so under the "Clifford Trust" rule, the grantor would be treated as the owner. He had a right to the income and a reversionary interest to take effect in possession or enjoyment within ten years. INT. REV. CODE OF 1954, §§ 677(a), 673(a). Here the grantor had no right to any part of the income, and his reversionary interest would not take effect until ten years and two months after the transfer. Thus, he had effectively given up ownership.

<sup>49</sup>Apparently the Internal Revenue is going to judge any transfer to a reversionary trust on the basis of the "Clifford Trust" rules in deciding whether a disposition takes place. This presents an interesting area for speculation. Payments on installment obligations usually break down into the return of capital portion, the profit portion, and the interest. Could the holder transfer the installment obligation into

Where a trustee holds installment obligations and transfers them to the trust beneficiaries in complete or partial liquidation of the trust, a disposition occurs which results in gain or loss to the trust. A 1955 ruling<sup>50</sup> holds that a distribution to a beneficiary by an inter vivos trust of unpaid installment obligations acquired from the sale of a capital asset accelerates the capital gain on termination of the trust. A tax court case<sup>51</sup> agreed with this result, when presented with a distribution to the beneficiaries without partition, because the interest became vested at the time of distribution.<sup>52</sup>

However, certain actions by the beneficiary do not count as a disposition of an installment obligation held in trust. Neither the transfer of the beneficiary's interest in the trust<sup>53</sup> nor his death means that the trust has disposed of any installment obligation, as long as the trust continues after the death.<sup>54</sup>

In the light of these decisions, the warning to the holder of an installment obligation, who is considering a transfer to a trust, is clear. The transfer will generally be a taxable event. In order to escape this result the holder must retain so many incidents of ownership, or reversionary rights, that the installment obligation becomes a particularly unattractive asset for any tax planning.

### STATUTORY EXCEPTIONS AND SPECIAL RULES

In most cases, an executor, a partnership, or a corporate holder of an installment obligation faces the same problems as other taxpayers in applying the rules for disposition. But there are special rules for some types of transfers based either on specific exceptions set out in the statute itself,<sup>55</sup> or on other Internal Revenue Code provisions which generally apply to the recognition of gain or loss.<sup>56</sup> Even here, however, there are

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trust with the return of capital and interest portion payable to someone else and retain the right to the profit portion, without causing a disposition?

<sup>50</sup>Rev. Rul. 55-159, 1955-1 CUM. BULL. 391; also I.T. 2589, X-2 CUM. BULL. 156 (1931).

<sup>51</sup>H. F. Shannon, 29 T.C. 702 (1958). While the trust will report the income, it will generally be able to deduct the amount, and the beneficiary will have to include it in taxable income.

<sup>52</sup>But this rule will not apply when a trust, which receives an installment obligation on the death of the holder, later terminates and transfers it to the beneficiaries. Treas. Reg. § 1.691(a)-4(b) (1957).

<sup>53</sup>Harold G. Ferguson, 34 B.T.A. 522 (1936).

<sup>54</sup>Detroit Trust Company (Low Estate), 34 B.T.A. 586 (1936).

<sup>55</sup>INT. REV. CODE OF 1954, § 453(d) (3) relates special rules for transfers caused by the death of a holder; § 453(d) (4) (A) deals with the liquidation of subsidiaries to which § 332 applies; § 453(d) (4) (B) applies to the complete liquidation of a corporation under § 337.

<sup>56</sup>Treas. Reg. § 1.453-9(c) (2) (1965) states: "Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751)."

certain dangers because these special rules are rather limited in their application.<sup>57</sup>

### *Transfer at Death*

Although the death of the holder actually causes a transfer of an installment obligation, it does not amount to a disposition for gain or loss to be reported in the decedent's final income tax return. Instead, it is treated as an item of "income in respect of a decedent" and the decedent's successor in interest to the obligation (the estate, or person entitled to the income by bequest or inheritance or because of the death) will continue to report the gain in the same manner as the decedent.<sup>58</sup>

This rule for nonrecognition of gain or loss also applies if there is a later transfer when the person entitled to the income dies before receiving it. The same result is reached when the estate transfers the installment obligation to a specific or residuary legatee; or when a trust, which has been bequeathed an installment obligation, terminates and transfers it to the beneficiary. In these cases the estate, legatee, or beneficiary reports the income when received.<sup>59</sup>

If, however, the estate or person entitled to the installment obligation by bequest, devise, or inheritance, or by reason of the death of the decedent, later sells, transfers, or satisfies it at other than face value, a disposition takes place. Then he must include in gross income the fair market value or consideration received, whichever is greater, reduced by the basis of the obligation in the hands of the decedent, adjusted to take into account any payments received after decedent's death and before the disposition.<sup>60</sup>

### *Transfer by Partners and Partnerships*

Since the specific partnership provisions in some instances supersede the provisions for immediate recognition of gain or loss on a disposition,

<sup>57</sup>There are also exceptions to the exceptions. Where an installment obligation is transferred directly or indirectly to a life insurance company any gain is recognized for tax purposes despite other provisions of the Internal Revenue Code providing for nonrecognition. This exception also covers transfers to a partnership of which the life insurance company is a member. INT. REV. CODE OF 1954, § 453(d) (5), Treas. Reg. § 1.453-9(g).

Also, INT. REV. CODE OF 1954, § 1038 provides that any gain found under its rules (reacquiring real property) is recognized notwithstanding any other Code provisions.

<sup>58</sup>INT. REV. CODE OF 1954, §§ 453(d) (3), 691(a); Treas. Reg. §§ 1.453-9(e) (1965), 1.691(a)-5(1965). The amount treated in this manner equals the excess of the face amount of the obligation over its bases in the hands of the decedent. INT. REV. CODE OF 1954, § 691(a) (4) (A); Treas. Reg. § 1.691(a)-5(1965). It also retains the same character (ordinary income or capital gain) that it had for the decedent. INT. REV. CODE OF 1954, § 691(a) (3). Further, the successor may take a deduction for any estate tax paid on this amount. INT. REV. CODE OF 1954, § 691(c).

<sup>59</sup>Treas. Reg. § 1.691(a)-4 (b) (1957). The transfer by an estate of an installment obligation received from a decedent to a legatee or a trust is different from a situation where the executor creates an installment obligation himself by a sale of estate assets and then transfers it to a testamentary trustee or an heir. See *supra* note 45.

<sup>60</sup>INT. REV. CODE OF 1954, § 691(a) (2); Treas. Reg. §§ 1.691(a)-4(a) (1957), 1.691(a)-5(b) and (c) (1965).

neither the partnership nor a partner recognizes any gain or loss on a contribution of an installment obligation to a partnership in exchange for a partnership interest.<sup>61</sup>

The application of these interrelated rules becomes more difficult when applied to a distribution to a partner of an installment obligation held by the partnership. The general rules state that the partnership realizes no gain or loss on a distribution of property (including money) to the partners; and that the partners, in turn, will not recognize any gain except to the extent that any money received exceeds the adjusted basis of the partner's interest in the partnership.<sup>62</sup> There is a partial exception to this rule for distributions representing a share of unrealized receivables and substantially appreciated inventory items. An ordinary gain may occur for both the partnership and a partner when a partner receives more or less than his partnership share of these items by giving up some of his interest in other partnership assets.<sup>63</sup> Thus, if a partner receives these items in exchange for giving up any part of his interest in other partnership property, or receives other property in return for his interest in these items, the transaction is treated as a sale or exchange between the parties with gain recognized to each.<sup>64</sup>

Normally, an installment contract should not be considered an unrealized receivable if the property sold was a capital asset. If the installment obligation represents accounts or notes receivable from the sale of goods or the rendering of services in the ordinary course of business, however, it will be treated as an unrealized receivable under these special rules.<sup>65</sup>

### *Disposition Rules for Corporations*

Some special rules must also be considered whenever an installment obligation is involved in a corporate organization, reorganization, distribution, or liquidation. The problem is doubly important here, because in some instances a particular transaction may impose a tax on the unreported gain for both the corporation and the stockholders.

<sup>61</sup>INT. REV. CODE OF 1954, § 721, Treas. Reg. § 1.721-1(a) (1956).

<sup>62</sup>INT. REV. CODE OF 1954, §§ 731(b), 731(a) (1), Treas. Reg. §§ 1.731-1(b) and (c) (1956). See also Treas. Reg. § 1.453-9(c) (2) (1965) at *supra* note 56.

<sup>63</sup>INT. REV. CODE \*6 1954, §§ 736, 751 (c). Rev. Rul. 57-68, 1957-1 CUM. BULL. 207. A pro rata distribution of these items in kind on a liquidation is not subject to these rules.

<sup>64</sup>Treas. Reg. § 1.751-1(b) (1) (i) (1965). Sale of part of a partnership interest is capital gain except to the extent of the unrealized receivables and substantially appreciated inventory items. Rev. Rul. 59-109, 1959-1 CUM. BULL. 168.

<sup>65</sup>INT. REV. CODE OF 1954, § 751 (d) (2). See also Rev. Rul. 60-352 at *supra* note 41, where a transfer of a limited partnership interest by gift was considered a taxable disposition of installment receivables held by the partnership.

Generally, the death, retirement, withdrawal of a partner, sale of a partnership interest, or the addition of a new partner should not be considered a disposition of the installment obligations by the partnership, if the partnership does not terminate at that time. INT. REV. CODE OF 1954, § 708(a); Treas. Reg. § 1.708-1 (1965). There will be some tax implications for the partner, however. INT. REV. CODE OF 1954, §§ 702 (a) (3), 736, 741.

A transfer of an installment obligation by the holder to a controlled corporation and a transfer in a nontaxable reorganization do not result in the recognition of gain or loss. In these cases other provisions in the Internal Revenue Code override the disposition rules generally applied.<sup>66</sup> Ordinarily, the transferee corporation in these situations will not have any taxable gain either. It merely steps into the transferor-holder's place, using the unrecovered cost at the time as its basis for the installment obligation, and treats the payments received in the same manner as the transferor.<sup>67</sup>

The same rules have been applied where the transferee was also the debtor on the installment obligation so that the creditor and debtor became one, and a cancellation of the installment obligation resulted by operation of law. This was the result reached in *Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner*.<sup>68</sup> In this case, the taxpayer organized a corporation receiving 78% of the stock for \$100,000 cash. Then the corporation bought his sole proprietorship business for \$100,000 cash down payment with the balance payable in annual installments. Some time later he transferred the balance left on the installment contract to the corporation in exchange for shares of its stock having an equal value. The Commissioner assessed a deficiency against the corporation, which was then both creditor and debtor on its obligation, under the theory that the cancellation of the installment in this manner amounted to a disposition resulting in taxable gain to the corporate transferee. The corporation contended that the transfer of this corporation debt to it in return for stock was exempted from taxation by Section 1032 of the Internal Revenue Code.

The court held that the cancellation of the debt in this manner was not a "disposition" or "transfer" of the obligation by the transferee corporation. It noted that the law dealing with the disposition of installment obligations applied to the seller of property giving rise to an installment obligation. It did not feel that the words "distributed, transmitted, sold or otherwise disposed of" could cover a cancellation of the obligation by the buyer of the property, further, it could find no authority for the proposition that the merger of a creditor and debtor, which effected a cancellation by law, amounted to a "transfer" of the installment obligation in this case.

At the same time, however, the court distinguished this situation from one involving the cancellation by the transferee of an installment

<sup>66</sup>Treas. Reg. § 1.453-9(c) (2) (1965) cited at *supra* note 55; INT. REV. CODE OF 1954, § 351 (nontaxable organization of a corporation), § 361 and 368 (nontaxable reorganizations of corporations). In Rev. Rul. 61-215, 1961-2 CUM. BULL. 110, the holder realized no gain or loss when his debtor merged into another corporation which continued the business. *Advanced Aluminum Castings Corporation v. Harrison*, 158 F.2d 922 (7th Cir. 1946) (*rehearing denied*, 1947), 47-1 CCH U.S. Tax Cas. ¶9113 has held that the merger of two corporations is not a disposition.

<sup>67</sup>INT. REV. CODE OF 1954, § 362, § 381(c) (8); Treas. Reg. § 1.453-9(c) (3) (1965).

<sup>68</sup>341 F.2d 466 (5th Cir. 1965) *rev'g and remanding*, 39 T.C. 500 (1962), 65-1 CCH U.S. Tax Cas. ¶9257.

obligation owed by a third party, who was not the transferee. In *Nebraska Seed Company v. United States*,<sup>69</sup> the holder of installment obligations resulting from the sale of assets to Y and P companies transferred all its assets (including the installment obligations) to U company in return for shares of stock in U company, and went out of business. The court held that no gain resulted to the holder at this time because the non-recognition provisions relating to corporate reorganizations place a limitation on the provisions dealing with installment obligations.

It then considered an unusual feature of the case, and held that the U company (transferee) realized the deferred profit under the particular facts. These facts showed that at the same time U company acquired the installment obligations, it also acquired all the assets and assumed all the liabilities of Y and P companies, the debtors or obligors of the installment obligations. Thus, U company (transferee), who was also the new holder, became both creditor and debtor, and this merger of parties worked a cancellation according to law. Nevertheless, under these conditions the court held that the U company should be taxed on the unrealized gain, reasoning that the general purpose of the law requires the holder of an installment obligation to report the deferred profit when realized. Here, profit was realized when the installment obligations held were offset by the liabilities assumed.

This case may seem to cast some doubt on the general rule that the transferee should not realize a taxable gain on the receipt of an installment obligation in a tax-free organization or reorganization of a corporation. However, the holding may rest on more than just the difference between a cancellation of a third party's liability and a transferee's liability under the installment obligation transferred. Apparently the transferee in this case became a new holder, and it was his actions in a second transaction outside the tax-free provisions for corporate reorganizations that accelerated the tax on the deferred profit.<sup>70</sup> In any event, one conclusion is clear: Even if the holder escapes a disposition under these rules, the transferee must consider his actions in the transaction to determine the tax consequences.

The distribution of an installment obligation by a corporation as a dividend produces a double tax. The general rule under which a corporation does not recognize gain or loss from the distribution of a dividend,

<sup>69</sup>116 F. Supp. 740 (Ct. Cl. 1953) cert. denied, 347 U.S. 1012, 53-2 CCH U.S. Tax Cas. ¶ 9658. *Jack Amman Photogrammetric Engineers, Inc.*, supra note 67, distinguished its conclusion from this case because here the installment obligation involved a third party obligation, not one of the transferee.

<sup>70</sup>The facts related do not clearly indicate that the transaction in which U company (the transferee and new holder) acquired the assets and liabilities of the debtor corporation obligors under the installment obligation also fell within the provisions for a tax-free reorganization, although both transactions apparently took place at the same time. Thus, it appears possible to argue that consecutive transfers under the tax-free provisions will not cause a disposition. That is, the holder of an installment obligation may first transfer it to a controlled corporation without any tax consequences. Then the new corporation (transferee) holder could participate in a tax-free organization or reorganization without causing a disposition.

expressly excludes installment obligations. In addition, the stockholders must pay tax on the fair market value of the installment obligation received as a dividend.<sup>71</sup>

Ordinarily, a corporation recognizes no gain or loss on distribution of property in partial or complete liquidation, but once again there is an exception in connection with installment obligations. Thus, a distribution of an installment obligation results in taxation of the unreported gain at that time. Further, the stockholders must account for the fair market value of the obligation in calculating their gain or loss on liquidation. In effect, this recognizes all of the unreported gain at the time of distribution to the stockholder, although the amount of tax due depends on his specific situation.<sup>72</sup> There are two limited statutory exceptions to these rules, however:

The first exception applies to a parent and subsidiary where at least 80% of the distributing company's stock is owned by another corporation which receives the assets on liquidation. In this case neither the subsidiary corporation nor the parent corporation realize any gain or loss. If the parent acquires the subsidiary's basis for the obligations, it continues to report the deferred gain as it receives the installment payments. If the basis of the parent corporation for the assets received is the cost of the subsidiary's stock, however, the subsidiary has disposed of its installment obligations and is taxed accordingly.<sup>73</sup>

The other limitation on the general rules for corporate liquidations cover the special 12-month liquidation. No gain or loss will result to the corporation by the distribution of an installment obligation if the obligation arose from the sale of assets after the adoption of the plan of liquidation. Thus, the distribution of any obligations from sales or exchanges of inventory or sales of any property made *before* the plan for liquidation, results in the recognition of gain or loss to the distributing corporation. Regardless of any gain or loss recognized by the corporation,

<sup>71</sup>INT. REV. CODE OF 1954, §§ 311(a), 301(b) (1) (A); Treas. Regs. 1.453-9(b) (3) (1965), example (2). Interstate Realty Company, 25 B.T.A. 728 (1932), acquiesced in XI-1 CUM. BULL. 4.

<sup>72</sup>INT. REV. CODE OF 1954, § 336 (for the corporation), §§ 331(a), 1001 (b) (for the stockholders); I.T. 3586, 1942-2 CUM. BULL. 65. At the same time, the corporation might not have a gain because the fair market value of the obligations do not exceed their basis. Emma M. Sanders, T.C. Memo. 1957-229, 16 CCH Tax Ct. Mem. 1041 (1957).

If the distribution involves the special one-month liquidation the distribution will increase the earnings and profits of the corporation by the amount of gain realized, which will increase the amount of any liquidating gain taxable to the stockholders as a dividend. INT. REV. CODE OF 1954, §§ 333, 333(e) (1).

<sup>73</sup>INT. REV. CODE OF 1954, §§ 332, 334(b) (1), 381(c) (8), and Treas. Reg. § 1.381(c) (8)-1 (1961) apply to a tax-free liquidation of a controlled subsidiary into a parent corporation.

INT. REV. CODE OF 1954, § 453(d) (4) (a) covers the subsidiary's situation. When depreciation is being recaptured under sections 1245 and 1250 through collections on installment obligations, there will be a recognized gain or loss, if the basis to the parent transferee is determined under § 334(b) (2). This section gives a new basis for the assets received by the parent equal to the purchase price of the subsidiary's stock. Treas. Reg. § 1.453-9(c) (1) (i) (1965). In this case, the subsidiary is considered to have disposed of its obligations.



the stockholders realize gain or loss on the liquidation to the extent that any money, plus the fair market value of the property received, exceeds the basis of their stock. Their basis for any installment obligations received in liquidation is the fair market value on the date of distribution.<sup>74</sup>

### CONCLUSION

Clearly Section 453 of the Internal Revenue Code of 1954 does more than give an attractive election for paying income tax on the gain resulting from the sale of property. Its provisions for acceleration of tax due on any deferred gain outstanding at the time the installment obligation is satisfied at other than face value, distributed, transmitted, sold, or otherwise disposed of, also sets a tax-trap for the unsuspecting. Thus, the holder of an installment obligation finds himself with an asset limited in use for any business or tax planning beyond the original transaction. If he considers a transfer by gift or in trust as part of estate planning, the income tax disadvantages will generally overcome most estate or inheritance tax advantages. An attempt to use the obligation in the ordinary course of business for a loan or a pledge as collateral security, or an attempt to modify the original transaction to meet changing conditions also presents some tax difficulties. Even when considered as part of a partnership or corporate reorganization or liquidation, the special rules and exceptions provide limited relief. In summary, it might be said: While the section may "giveth," it may also "taketh away."

<sup>74</sup>INT. REV. CODE OF 1954, §§ 337, 453(d) (4) (B). If the installment obligations represent any portion of depreciation recapture, however, and they are distributed before the corporation has reported it all because of the installment method of reporting, the distribution will result in the acceleration of that gain in spite of this exception. Treas. Reg. § 1.453-9(c) (1) (ii) (1965). See also, INT. REV. CODE OF 1954, §§ 331, 1001, for the tax effect to the stockholders.

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